NO. 16395

United States
Court of Appeals
for the Ninth Circuit

COMMISSIONER OF INTERNAL REVENUE,
Petitioner

vs.

J. I. MORGAN AND FRANCES MORGAN,
Respondents

On Petition for Review of the Decision of the Tax Court of the United States

BRIEF FOR THE RESPONDENTS

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PRELIMINARY STATEMENT

This is an appeal by the Commissioner of Internal Revenue from that part of an adverse decision of the Tax Court of the United States which determined that the annual increases in the excess of the cash value of an Investors Syndicate Certificate over the amounts paid in by the respondent, J. I. Morgan, did not constitute ordinary income to him during the years of increase, but should properly be reported by him as capital gain upon retirement at the maturity thereof. (Tr. 31-32).

In 1937 respondent, J. I. Morgan, acquired an "Accumulative Investment Certificate," Series F-232668, from Investors Syndicate (presently known as Investors Diversified Services, Inc.) of Minneapolis, Minnesota. The certificate provided for annual advance payments by respondent of $600 for 15 years. It stipulated a cash value at the end of each year (available only if the certificate is surrendered). During the first six years, the cash value is less than the payments made by the purchaser. Thus, at the end of the first year, when $600 has been paid in, the cash value is only $220; at the end of the second year, when $1,200 has been paid in, the surrender value is $670; and at the end of the sixth year, when $3,600 has been paid in, the cash value is $3,500. Beginning only with the seventh year, the cash value exceeds the aggregate amounts paid in by the purchaser. (Tr. 30). The certificate does not provide for the payment of interest by the issuing company. At the expiration of 15 years, the issuing company agreed to pay to Morgan (with certain options) the sum of $12,500. In 1952, Morgan exercised one of the available options to extend the certificate for an additional period of not more than 10 years. (Tr. 29). During the years 1950, 1951, 1952, 1953 and 1954, the yearly increase in the excess of the surrender value over the amounts paid in by Morgan amounted respectively to $450, $500, $700, $520 and $570. (Tr. 30). Such "yearly increase" is, however, not payable separately; it is available only if the certificate is surrendered.

Despite the provisions of Sec. 117 (f) of the Internal Revenue Code of 1939 and Sec. 1232 (a)(1) of the Internal Revenue Code of 1954, the Commissioner of Internal Revenue takes the position that such amounts constituted ordinary income to J. I. Morgan in the respective years. Respondents contend, and the Tax Court so held, that the entire increment is taxable only upon retirement at maturity as capital gain under these provisions of the respective internal revenue codes.

The fact that respondents kept their books of account and prepared their income tax returns on an accrual basis (Tr. 7) does not affect the basic question, since "appreciation in value of property is not even an accrual of income to a taxpayer prior to the realization of such appreciation through sale or conversion of the property". Reg. 111, Sec. 29.41-2; Reg. 118, Sec. 39.41-2(a).

STATUTES INVOLVED

Internal Revenue Code of 1939:

Sec. 22. Gross Income.

(a) General Definition. — "Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever.

Sec. 117. Capital Gains and Losses.

(f) Retirement of Bonds, Etc.—For the purposes of this chapter, amounts received by the holder upon the retirement of bonds, debentures, notes, or certificates or other evidences of indebtedness issued by any corporation (including those issued by a government or political subdivision thereof), with interest coupons or in registered form, shall be considered as amounts received in exchange therefor.

Internal Revenue Code of 1954:

Sec. 61. Gross Income Defined.

(a) General Definition — Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

. . . . .

(4) Interest;

Sec. 1232. Bonds and Other Evidences of Indebtedness.

(a) General Rule.—For purposes of this subtitle, in the case of bonds, debentures, notes, or certificates or other evidences of indebtedness, which are capital assets in the hands of the taxpayer, and which are issued by any corporation, or government or political subdivision thereof—

(1) Retirement. — Amounts received by the holder on retirement of such bonds or other evidences of indebtedness shall be considered as amounts received in exchange therefor (except that in the case of bonds or other evidences of indebtedness issued before January 1, 1955, this paragraph shall apply only to those issued with interest coupons or in registered form, or to those in such form on March 1, 1954).

SUMMARY OF ARGUMENT

I.

With respect to the years 1950 to 1953 inclusive, the specific provisions of Sec. 117(f) of the Internal Revenue Code of 1939 override the broad general provisions of Sec. 22(a) thereof, and with respect to the year 1954, the specific provisions of Sec. 1232(a)(1) of the Internal Revenue Code of 1954 override the broad general provisions of Sec. 61(a) thereof.

II.

The historical background of Sec. 117(f) demonstrates that upon retirement amounts received in exchange for a bond include the initial discount on the issuance of the bond and that the entire amount received upon retirement is entitled to capital gains treatment.

III.

The phraseology employed in Sec. 117(f) "amounts received . . . upon retirement . . . shall be considered as amounts received in exchange" (for the bond), is the familiar form used by Congress to connote capital gain treatment.

IV.

There is no evidence in the record that the increment in the certificate is accruable as "interest".

V.

In enacting Sec. 1232(a)(1) of the Internal Revenue Code of 1954, Congress intended ordinary income treatment (for original discount) only for instruments issued subsequent to December 31, 1954; and with respect to such instruments, ordinary income accrues only upon their disposition.

ARGUMENT

In *Caulkins* v. *Commissioner,* 144 F. 2d 482, affg. 1 T.C. 656, the United States Court of Appeals for the Sixth Circuit squarely decided that the increment received on retirement of an "Accumulative Investment Certificate" was taxable as a capital gain under Section 117(f), and not as ordinary income, even though such increment may be in the nature of interest. The certificate there involved was the same type of certificate here in issue; and indeed, issued by the same Investors Syndicate. The *Caulkins* decision is well reasoned and has been consistently followed. Only recently, the Tax Court, in reaffirming *Caulkins,* observed in *Goodstein* v. *Commissioner,* 30 T.C. 1178 (1958), that the Commissioner "has cited no intervening judicial authority which would indicate that the Caulkins case was incorrectly decided nor has any come to our attention."

In *Caulkins,* the Sixth Circuit ruled that the increment was taxable as capital gain "under the plain wording of §117(f)" adding: "a provision that the increment in such cases should be taxable under §22(a) might or might not have been wise and fair; but Congress has not enacted it, and the courts cannot supply it by judicial legislation." For a decade Section 117(f) remained unchanged and it was only until the enactment of the 1954 Internal Revenue Code that the capital gains treatment was removed, but only in respect of evidences of indebtedness issued after December 31, 1954.

In *Caulkins,* the Commissioner argued that the increment actually received upon retirement was taxable as ordinary income, rather than capital gain. Here, the Commissioner's position is more extreme, arguing that the increment is taxable as ordinary income in the year of increment. To prevail, the Commissioner must establish not only (a) that the increment is taxable as ordinary income, but also (b) that the increment is accruable in the year of increment. To prevail, the Commissioner must not only overcome the rule in *Caulkins,* but the latter proposition must also be established.

The Commissioner of Internal Revenue at first refused to follow the *Caulkins* decision, CB 1943, p. 28, and then withdrew his nonacquiescence, CB 1944, p. 5. Some nine years later, in Revenue Ruling 119, CB 1953-2, p. 95, the Commissioner stated that "This decision should be limited precisely to what was there decided under the particular facts of that case."* After the enactment of the Internal Revenue Code of 1954, the Commissioner reversed his position in CB 1955-1, p. 7, withdrawing his acquiescence in *Caulkins.* However, no judicial authority was advanced to support the Commissioner's change of position.

We respectfully submit that the *Caulkins* case was decided correctly (and properly accepted by the petitioner herein for a period of more than ten years) and should be followed by this Court for the following reasons:

I.

With respect to the years 1950 to 1953 inclusive, the spe-

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*For a perceptive analysis of this general question and a criticism of Revenue Ruling 119, see Janin, "The Israeli Bond Ruling: Legislation By Administrative Fiat?", March, 1955 Taxes—The Tax Magazine, at page 191.

cific provisions of Sec. 117(f) of the Internal Revenue Code of 1939 override the broad general provisions of Sec. 22(a) thereof, and with respect to the year 1954, the specific provisions of Sec. 1232(a)(1) of the Internal Revenue Code of 1954 override the broad general provisions of Sec. 61(a) thereof.

There is no doubt that the increment in value of the certificate held by J. I. Morgan is taxable. The real issue is how the increment is to be taxed and when. The Commissioner labels the increment as "interest" and concludes that it is accruable and taxable in the years in question as ordinary income under Sec. 22(a) of the 1939 Code and Sec. 61(a) of the 1954 Code. The real issue, however, is how Congress chose to tax such increment. Congress has seen fit to remove the increment from the broad general provisions of Sections 22(a) and 61(a) and has provided that it be taxed under the specific provisions of Sec. 117(f) of the 1939 Code and Sec. 1232 of the 1954 Code. This is, in effect, what the Court of Appeals for the Sixth Circuit held in the *Caulkins* case (in respect of the 1939 Code).

As in the case at bar, the Commissioner, in *Caulkins,* contended that Section 117(f) "was not intended to cover the gain from interest, but only capital gain; . . . that the increment here is identical with interest compounded at 5½% during the agreed period; . . . . that the increment in value of the certificate constitutes compensation for the use of the taxpayer's money, . . . and that as such, it must be taxed in its entirety as ordinary income under §22(a)".*

The Circuit Court reasoned that Congress had not made the differentiation urged by the Commissioner, stating that "the decisive question is whether the amount received by the taxpayer falls within Section 117(f)***". It concluded that the increment was covered "under the plain wording of Section 117(f)". The Court thus recognized that the specific provisions of a particular statute—Section 117(f)—override the provisions of a general statute—Section 22(a).

Section 117(f) is, however, not a one-way street, for it mandates not only capital gains but also capital losses, rather than ordinary losses, to the detriment of a taxpayer. Unlike *Caulkins,* the situations of the Commissioner and the taxpayer were reversed in a case involving the question of whether a loss arising from the redemption of corporate securities was deductible as a bad debt under Sec. 23(k) of the 1939 Code, or whether such loss had to be treated as a capital loss under Sec. 117(f). The Supreme Court held in *McClain v. Commissioner of Internal Revenue,* 311 U.S. 527, 61 S. Ct. 373, that the word "retirement" appearing in Sec. 117(f) covered this situation. The Court stated:

"It is plain that Congress intended by the new sub-

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*In *Caulkins,* there was direct testimony by an officer of the issuing company that the difference between the amount paid in and the amount received at maturity would be equal to 5½% of the amount paid in. No such evidence is present in the case at bar.

section (f) to take out of the bad debt provision certain transactions and to place them in the category of capital gains and losses."

In *Caulkins,* the Tax Court, after quoting this passage in *McClain,* reasoned (1 T.C. at 661):

> "This tribunal has held that by a parity of reasoning Congress also intended to take out of the ordinary income provisions of the revenue act gains realized by a taxpayer in connection with the retirement of the specified obligations. *William H. Noll,* 43 B.T.A. 496".

In effect, the Commissioner seeks to limit the statutory language, ". . . amounts received . . . upon the retirement" to the "capital" element and to exclude therefrom the increment of the type here involved. The statutory language of Section 117(f) does not permit of any such limitation. As was stated by the Tax Court in *Paine* v. *Commissioner,* 23 T.C. 391, 401 (1954) rev'd. on other grounds, 236 F. 2d 398 (8th Cir. 1956):

> "The effect of the holding in the *Caulkins* case is, therefore, that any increment realized on the retirement of an obligation which qualifies within the meaning of Section 117(f)***is part of *that amount* which is deemed to have been received as a result of an exchange, and is thus entitled to capital gains treatment.
>
> "We think it is clear that the decision in the *Caulkins* case was based solely upon the precise language of Section 117(f) which left no doubt that the *entire* amount received as a result of retirement of notes in registered

form was to be deemed received in exchange for such notes despite the recognition by both Courts that the increment there under consideration was essentially interest.***

(Italics in opinion)

Much the same argument advanced here was pressed by the Commissioner in *Commissioner* v. *Winslow,* 113 F. 2d 418 (1st Cir. 1940), affg. 39 B.T.A. 373 (1939). The taxability of life insurance proceeds payable in installments was there involved. The Commissioner argued that the language of the statute—"amounts received under a life insurance contract paid by reason of the death of the insured"—should be limited to the capital payments payable by reason of the insured's death and that the "interest" increment reflected in the installments was outside the purview of the statutory language. That construction was rejected. Said the Circuit Court: "The language of this section . . . is to be interpreted in its ordinary and natural meaning".

See also: *Commissioner* v. *Carman,* 189 F. 2d 363 (2d Cir. 1951), affg. 13 T.C. 1029 (1949); *Pierce Corp.* v. *Commissioner,* 120 F. 2d 206 (5th Cir. 1941).

In *Lurie* v. *Commissioner,* 156 F. 2d 436, this Court in 1946 ruled that Section 117(f) must be interpreted in accordance with the language employed, and rejected the Commissioner's attempt to read into Section 117(f) a limitation not contained in the statute; viz, that the evidence of indebtedness must be in registered form for a specified period prior to retirement.

II.

The historical background of Sec. 117(f) demonstrates that upon retirement amounts received in exchange for a bond include the initial discount on the issuance of the bond and that the entire amount received upon retirement is entitled to capital gains treatment.

Section 117(f) had its historical genesis in *I.T. 1637,* II-1 C.B. 36 (1923). At issue was the taxable character of a profit of 6x dollars to be realized by the holder upon the maturity of a non-interest bearing state obligation originally issued at a discount (issued at 88). The Bureau of Internal Revenue reasoned: "When an obligation matures it is neither sold nor exchanged" and thereupon ruled that the 'taxable profit derived upon maturity . . . is, therefore, not 'capital gains' derived from the sale or exchange of capital assets . . . ". Although part or all of the 6x dollars manifestly represented "interest increment", in the Commissioner's terminology (the obligations having originally been issued at a discount of 12x dollars), the taxability thereof turned solely on the question as to whether a redemption constituted a sale or exchange—not whether discount is the equivalent of interest.

The Bureau's rationale was rejected in *Henry P. Werner,* 15 B.T.A. 482 (1929), in an unanimous decision of the Board of Tax Appeals. The taxpayer had purchased in 1920 certain 20-year convertible debenture 5% bonds for $8,870 directly from the corporate obligor—at a discount. In 1923 the bonds were called for redemption and the taxpayer received $11,000 cash in redemption of the bonds, realizing a profit of $2,130.

As explicitly stated in the opinion, the sole issue posed by the contending parties was whether a redemption constituted a sale or exchange. No suggestion emanated from the Commissioner—and, indeed, the Board did not consider—whether the original discount was the equivalent of interest and, hence, taxable as such when realized by the bondholder. The Board observed that Congress intended to accord capital gains treatment to the "sale or other disposition of assets" and concluded that the redemption of the bonds "certainly . . . comes within these broad terms", (15 B.T.A. at 485).

The Bureau thereupon issued *I.T. 2488,* VIII-2 C.B. 127 (1929), announcing its adherence to the *Werner* rationale, and revoking *I.T. 1637.* The ruling declared that the net gain from bonds (held for more than two years), whether received as the result of the maturity of the bonds or as the result of their redemption before maturity was taxable as a capital gain—with no suggestion that capital gain treatment was to be limited to capital appreciation or that any interest element or increment was to be excluded therefrom. It cited the *Werner* case for the proposition that "the redemption of bonds at a 'called' date for an amount in excess of the cost of the bonds to the bondholder results in a gain from the sale or exchange of capital assets . . .". It was then the "amount in excess of the cost of the bonds" which qualified for capital gain, irrespective of its character as capital appreciation or interest increment.

At the close of 1932, the *Werner* decision was expressly overruled by the Board of Tax Appeals in *John H. Watson, Jr.,* 27 B.T.A. 463 (1932). The issue posed was whether a loss upon redemption of Liberty Loan Bonds was an ordinary loss or a capital loss. The Board now reasoned: "Payment of the amounts specified in the bonds, either at maturity or pursuant to an authorized call prior to maturity, is not a 'sale or exchange' of such bonds. It is merely the payment of an obligation according to its fixed terms. . . . Loss incurred or gain realized in such a transaction is not a capital loss or a capital gain under the definition found in the statute" (27 B.T.A. at 465).

In 1933, the Bureau issued *I.T. 2678,* XII-1 C.B. 117 (1933), announcing its adherence to the *Watson* decision, and revoking *I.T. 2488.*

Section 117(f) was first enacted as a part of the 1934 Revenue Act, upon the recommendation of the American Bar Association, to clarify the uncertainty caused by these apparently conflicting decisions of the Board of Tax Appeals. Of particular significance is the fact that the memorandum submitted to Congress by the American Bar Association made reference to the *Werner* case, for that case involved gain realized (representing original discount) on a bond acquired by the holder directly from the obligor.

The American Bar Association urged Congress to make the statute show clearly that the gain involved in the *Werner* case was entitled to the benefits of the capital gains provisions even though only a retirement was involved.* Thus, it is clear that when Sec. 117(f) was written, the fact of original discount on issuance of bonds was presented to Congress, yet Congress did not prescribe a different method of taxation for such discount; rather it gave the benefits of capital gains to such discount, and any other appreciation realized by the holder, on retirement of a bond.

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*In support of its recommendation, the American Bar Association stated:

"Section 101(c) of the 1932 Act defines capital gains and losses as the gains or losses resulting from the 'sale or exchange' of capital assets. The United States Board of Tax Appeals has determined in *Henry R. Werner*, 15 B.T.A. 482, that included within the terms of 'sale or exchange', was the redemption by the obligor, at or before maturity, of a capital asset. Later, the Board held in *Watson*, 27 B.T.A. 463, that such redemption was not a 'sale or exchange'. Your committee believes that the Congress did not intend to remove from the benefits of the capital gains and loss provisions gains or losses from the redemption of capital assets, especially when such gains or losses if the assets had been sold by the holder immediately before redemption, would be considered capital gains or losses." See *Hearings, Senate Finance Committee, 73d Cong., 2d Sess., on H.R. 7835, p. 76.*

III.

The phraseology employed in Sec. 117(f) "amounts received . . . upon the retirement . . . shall be considered as amounts received in exchange" (for the bond), is the familiar form used by Congress to connote capital gain treatment.

A complete or partial liquidation of a corporation is not a sale or exchange and would, under ordinary circumstances, not give rise to capital gain or loss. The technique employed by Congress to give such transactions the benefits of the capital gains and loss provisions was to provide (Section 115-(c), 1939 Code):

> "Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and the amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock."

A distribution in complete or partial liquidation of a corporation may represent in whole or in part a distribution of earnings or profits. A distribution of earnings or profits, if not pursuant to a plan of liquidation, would be a dividend and taxable as ordinary income (Section 115(a), 1939 Code). The Commissioner has never contended, as he does here, that the portion of the distribution in liquidation representing earnings or profits was not covered by the language "in exchange for the stock" and should be taxed as ordinary income rather than capital gain. Such a construction of Section 115(c) is precluded by the statutory language employed and for the same reason such construction of Section 117(f) is also precluded.

The language of Section 115(c) (1939 Code) has been carried forward into the 1954 Code (see Section 331(a).)*

In ordinary circumstances, the cancellation of a lessee's lease or of a distributorship agreement is not a sale or exchange and therefore will not be entitled to the benefits of the capital gains provision. Congress, however, decided that such amounts should result in capital gain and the technique employed was the adoption of language virtually identical with the crucial words in Section 117(f). Thus, Section 1241 of the 1954 Code reads:

> "*Amounts received* by a lessee for the cancellation of a lease, or by a distributor of goods for the cancellation of a distributor's agreement (if the distributor has a substantial capital investment in the distributorship), *shall be considered as amounts received in exchange* for such lease or agreement." (emphasis supplied)

In explanation of this provision the Senate Committee Report stated:

> "Your committee has taken action to insure certain

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*See also *Rev. Rul. 57-243* in which the Internal Revenue Service ruled that the characterization in Section 331(a) was not limited to any particular section and was applicable to any type of transaction covered by the Code. In the same manner Section 117(f) characterizes the transaction as an exchange. As a consequence, amounts received which might otherwise be taxed as ordinary income are given the benefits of capital gain treatment.

types of transactions will be regarded as sales and thus may give rise to capital gain or loss" (S. Rept. No. 1662, 83d Cong., 2d Sess, 1954, p. 115).

IV.

There is no evidence in the record that the increment in the certificate is accruable as "interest".

The record in the instant case does not appear to include any facts which would demonstrate that the annual increments in question represented interest at some specified rate. As the record shows, (Tr. 30) at the end of the sixth year the cash value of the certificate was less than the amount paid in by J. I. Morgan. This can hardly be said to be the consequence of an interest computation. If income is realized in the years in which the aggregate increment exceeds the aggregate amount paid in, then it would appear that a deduction should be allowed in the years in which the cash value is less than the amount paid in. We very much doubt, however, that the Commissioner would allow such a deduction. The annual increases in value of the certificate involved in this case are not constant and do not appear to be susceptible of an interest computation.

Of critical importance is the fact that the increment is not available to the holder of the certificate without its surrender. Thus, the increment is substantially different from the interest coupon on a bond which may be detached and cashed without affecting the bond itself. Here the increment can be realized only when the investment is terminated.

The certificate here involved is more akin to an insurance contract in which the cash surrender value first is less than and thereafter may exceed the aggregate amount of premiums paid. The increment in surrender value of an insurance contract has never been held to constitute "interest" even though it may contain elements of interest. Furthermore, the increment has never been held realized for tax purposes until the policy is surrendered.

The Investors Syndicate Certificate held by J. I. Morgan is more akin to an investment on which gain or loss is realized upon disposition. Mere appreciation is not subject to tax. The fact that the holder of the instrument has the power to dispose of the instrument and receive the increment is in and of itself not the accrual event. In the same manner, the holder of a share of stock which has appreciated in value may realize the appreciation by sale, but will not, prior to the sale, be required to accrue appreciation for tax purposes. So, too, the beneficiary of a pension plan may obtain the pension benefits by leaving the employ of the company, but this right so to do does not require him to accrue the potential income for tax purposes. In all these situations the income does not "accrue"—it is realized only upon the disposition of the investment.*

Finally, it should be noted that the original discount or increment in instruments issued *after* December 31, 1954, are not taxed by Sec. 1232 of the 1954 Code as interest income, but only as gain from the sale or exchange of property which is not a capital asset. Such a gain accrues only upon the disposition of the asset and not ratably during the time it is held by the taxpayer.

V.

In enacting Sec. 1232(a)(1) of the Internal Revenue Code of 1954, Congress intended ordinary income treatment for original discount only for instruments issued subsequent to December 31, 1954; and with respect to such instruments, ordinary income accrues only upon their disposition.

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*This principle is reflected in a recent Letter Ruling, dated April 21, 1959 (1959 Prentice-Hall Federal Tax Service, par. 54864), holding that regular earnings credited to a savings and loan association bonus savings account are not taxable until the year of withdrawal or termination. Under the plan, the depositor made $10 monthly deposits until the amount, plus earnings credited by the association, equaled $2,000. In addition to the regular earnings, the plan provided a long term bonus of one percent, or a percentage thereof, if the depositor did not withdraw from the plan for a specified number of months. Revoking an earlier Letter Ruling, dated January 31, 1958 (1958 Prentice-Hall Federal Tax Service, par. 54786), the Service now ruled that the regular earnings (credited semi-annually) and the bonus are taxable only in the year in which the long term bonus period of 156 months terminates, or in the year of actual withdrawal, whichever occurs earlier, on the ground that the depositor must withdraw from the plan in order to secure the accumulated semi-annual earnings and the interim bonus earned up to that time, and by such withdrawal, the right to accumulations towards a larger bonus would be forfeited.

As previously noted, the Commissioner's acquiescence in the *Caulkins* case was not withdrawn until 1955. When the 1954 Internal Revenue Code was enacted, therefore, the Commissioner's acceptance of the *Caulkins* rule was a matter of record. When Congress enacted Sec. 1232(a) of the 1954 Code, it was clearly cognizant of the effect of the *Caulkins* case upon Sec. 117(f) of the 1939 Code and this recognition is reflected in Sec. 1232(a) of the 1954 Code. In explanation of the 1954 amendment, the Report of the House Committee on Ways and Means (accompanying H.R. 8300, General Explanation, Section XXVII, Subdivision E) stated:

> "*Under existing law* any gain realized from a corporate or Government bond in registered form or with coupons attached is treated as a capital gain either if the bond is held to retirement or if it is sold or exchanged. Part or all of this gain, however, may represent discount on original issue which is a form of interest income and, in fact, is deductible as an interest payment by the issuing corporation.
>
> "*Effective with respect to bonds issued after December 31, 1954,* the committee bill provides that any gain realized by the holder of a bond attributable to the original issue discount will be taxed as ordinary income.***"

(emphasis supplied)

Section 1232(a)(1) provides:

> "General rule.—For purposes of this subtitle, in the case of bonds, debentures, notes, or certificates or other evidences of indebtedness, which are capital assets in the hands of the taxpayer, and which are issued by any

corporation, or government or political subdivision thereof—

> (1) Retirement. — Amounts received by the holder on retirement of such bonds or other evidences of indebtedness shall be considered as amounts received in exchange therefor (except that in the case of bonds or other evidences of indebtedness issued before January 1, 1955, this paragraph shall apply only to those issued with interest coupons or in registered form, or to those in such form on March 1, 1954)."

The above section makes very clear the rule that an amount received upon a retirement of a note is received in exchange therefor. The exception stated in the parenthetical clause at the end is not applicable here because the instrument involved in this case was in registered form on March 1, 1954. However, the fact that an exception is stated indicates Congressional recognition of the possibility that the 1954 Code would become applicable to instruments issued before January 1, 1955 and not in registered form on March 1, 1954. As to such instruments, Sec. 1232(a)(1) did not apply. But as we have previously noted, the instrument here involved was in registered form on March 1, 1954 and therefore the general rule stated in Sec. 1232(a)(1) does apply.

Section 1232(a)(2)(A) provides:*

"General rule.—Except as provided in subparagraph (B), upon sale or exchange of bonds or other evidences

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*As amended by the Revenue Act of 1958.

of indebtedness issued after December 31, 1954, held by the taxpayer more than 6 months, any gain realized which does not exceed—

(i) an amount equal to the original issue discount (as defined in subsection (b),) or

(ii) if at the time of original issue there was no intention to call the bond or other evidence of indebtedness before maturity, an amount which bears the same ratio to the original issue discount (as defined in sub-section (b)) as the number of complete months that the bond or other evidence of indebtedness was held by the taxpayer bears to the number of complete months from the date of original issue to the date of maturity,

shall be considered as gain from the sale or exchange of property which is not a capital asset. Gain in excess of such amount shall be considered gain from the sale or exchange of a capital asset held more than 6 months."

The above subsection is inapplicable here because it relates only to evidences of indebtedness issued after December 31, 1954. However, when the section refers to sale or exchange of bonds, it also includes a retirement of bonds by reason of Section 1232(a)(1). Thus, a retirement is a sale or exchange under 1232(a)(2), which does not apply to the taxpayer herein, and under 1232(a)(1) which does apply to the taxpayer herein.

Section 1232(a)(1) and Section 1232(a)(2) must be read together. Consider, for example, the situation which occurs when an instrument issued after December 31, 1954 is retired. Section 1232(a)(2) standing by itself is not applicable because it covers only sales or exchanges. It is necessary to look to Section 1232(a)(1), which defines sale or exchange to include retirement, before the tax consequences of the transaction can be determined.

If Congress had intended ordinary income treatment for instruments issued before January 1, 1955 and retired during a 1954 Code year, it could easily have so provided. However, Congress saw fit to give ordinary income treatment only to obligations issued after December 31, 1954 and it follows that Congress did not intend ordinary income treatment to instruments issued before January 1, 1955 which qualified under Section 1232(a)(1). Obligations which do not qualify under 1232(a)(1), such as those which were not in registered form on March 1, 1954, receive ordinary income treatment because a retirement is not deemed an exchange therefor.

Furthermore, with respect to those instruments which were subjected to ordinary income treatment, Congress decided that the ordinary income would accrue only upon the disposition of the obligation and not during its existence. Accordingly, Congress provided, in Section 1232(a)(2), that the ordinary income would accrue as gain from the sale or exchange of property which is not a capital asset only when the instrument was sold, exchanged or (by reference to Section 1232(a)(1)) retired.

Of significance also is the fact that no ordinary income treatment is charged to instruments issued after December 31, 1954 if the original discount is less than one-fourth of one per cent of the redemption price at maturity multiplied by the number of complete years to maturity (see Section 1232(b)(1)).

The regulations also support the contention made here. Thus, Section 1.1232.1(a) provides:

> "In general. Section 1232 applies to any bond, debenture, note, or certificate or other evidence of indebtedness (referred to in this section and §§1.1232-2 through 1.1232-4 as an obligation) (1) which is a capital asset in the hands of the taxpayer, and (2) which is issued by any corporation, or by any government or political subdivision thereof. In general, section 1232(a)(1) provides that the retirement of an obligation, other than certain obligations issued before January 1, 1955, is considered to be an exchange and, therefore, is usually subject to capital gain or loss treatment; and section 1232(a)(2) provides that in the case of a gain realized on the sale or exchange of certain obligations issued at a discount after December 31, 1954, a portion of the gain constitutes ordinary income.***"

The first sentence of the above quotation indicates that Section 1232 applies to *any* bond, note, etc., which is a capital asset in the hands of the taxpayer and which is issued by a corporation. The instrument here involved clearly so qualifies. The first portion of the second sentence states that the retirement of an obligation "is considered to be an exchange and, therefore, is usually subject to capital gain or loss treatment". The exception in the sentence for obligations issued before January 1, 1955 refers to those obligations which were not in the required form on March 1, 1954. Thus, the regulation confirms the statutory interpretation advanced here.

Finally, Section 72(e) and Section 72(1) of the 1954 Code made crystal clear that the increment, even where treated as ordinary income (namely, on instruments issued after December 31, 1954) is not taxable until the disposition of the instrument. The increment on the type of instrument here involved is accorded the same tax treatment as an "endowment contract" (see Section 72(1)); and like an endowment contract, it is the lump sum receivable upon surrender or maturity of the certificate which is taxable and the amount so taxable can be spread over three years (Section 72(e)(3)). The Committee Report declares that "certain relief provisions applicable to endowment contracts will be applied also to face-amount certificates". S. Rept. No. 1662, 83d Cong., 2d Sess., (1954) p. 436. Obviously, the relief provisions would be frustrated if the increment were to be taxed in the successive years when the increment occurred, rather than in the year of retirement or surrender when the lump sum payment was received by the holder of the instrument.

CASES CITED BY PETITIONER

We believe that the cases cited by the Commissioner in his brief are easily distinguishable. In *Paine* v. *Commissioner,* 23 T.C. 391, reversed on other grounds, 236 F.2d 398, the instruments involved were not in registered form and, therefore, not covered by Section 117(f). *United States* v. *Snow,* 223 F.2d 103, and *Tunnell* v. *United States,* 259 F.2d 916, involved disposition of a partnership interest in which income had accrued to the selling partner prior to the sale. Again, these are situations not defined in Section 117(f) and, therefore, not pertinent to this controversy.

Shattuck v. *Commissioner,* 25 T.C. 416, involved a situation in which bonds were issued at face and provided for specific payments of interest. The Tax Court carefully distinguished Section 117(f), pointing out, at page 423 of the opinion, that it did not embrace the portion of the amount paid by the obligor which represents the discharge of the obligor's existing obligation to pay accrued and defaulted interest on the bonds. *Tobey* v. *Commissioner,* 26 T.C. 610, involved a situation substantially similar to *Shattuck,* and Section 117(f) was held inapplicable on the same grounds. *Fisher* v. *Commissioner,* 209 F. 2d 513, involved defaulted interest on bonds which were not in registered form.

In no case cited by the Commissioner in his brief was the rule of the Caulkins case disaffirmed or even questioned. The Court of Appeals for the Sixth Circuit, which decided the Caulkins appeal, found it unnecessary to reverse itself in deciding the *Snow* and *Fisher* cases.

It is interesting to note that the Commissioner has failed to cite two recent decisions of the Tax Court which adhere to the rule of the *Caulkins* case. *Kormendy* v. *Commissioner,** T.C. Memo 1959-72, filed April 15, 1959; *Goodstein* v. *Commissioner,* 30 T.C. 1178 (1958). In *Goodstein* the Commissioner made much the same argument as he does here and was repulsed by the Tax Court. Said the Tax Court: "The instant case falls squarely within the holding in the *Caulkins* case. The various contentions were carefully analyzed by this Court and by the Court of Appeals for the Sixth Circuit in the *Caulkins* case, and it was concluded that under the language of Section 117(f) there was no alternative to holding that the full amount received upon redemption was to be treated as amounts received in exchange for the evidences of indebtedness there involved. In the instant case the respond-

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**Kormendy* involved the taxability of the increment upon retirement in 1954 of certificates similar to the type of certificate here. In reaffirming *Caulkins* the Tax Court said:

"This Court has very recently reaffirmed and followed its decision in the *Caulkins* case, in *J. I. Morgan, Inc.,* 30 T.C. 881 (July 9, 1958), on appeal (C.A. 9, Dec. 11, 1958), and in *Eli D. Goodstein,* 30 T.C. 1178 (Aug. 28, 1958) on appeal (C.A. 1, Dec. 30, 1958). Respondent makes no effort to distinguish any of the above three cases from the cases at bar. We think the decisions of this Court in those cases are squarely in point here and control our decision in the present cases. The cases cited by respondent do not support his theory.

"Accordingly, following the decision of this Court in the *Caulkins* case, we conclude that under section 117(f) of the 1939 Code and section 1232(a)(1) of the 1954 Code the gain on the redemption of the certificates here involved were properly reported by petitioners as capital gains."

ent advances no additional arguments in support of his position. He has cited no intervening judicial authority which would indicate that the *Caulkins* case was incorrectly decided nor has any come to our attention. Under the circumstances, we adhere to the position previously taken in the *Caulkins* case and hold that the petitioners properly reported their gain on the redemption of the debentures as long-term capital gain,***"

Initially, the Commissioner filed a notice of appeal with respect to this issue resolved against him in the *Goodstein* case but, thereafter, withdrew the appeal.

CONCLUSION

We respectfully submit that the basic issue is not whether the annual increment in value of the certificate involved here is in the nature of interest but, rather, how Congress chose to tax such increment when it enacted Section 117(f). As the Court of Appeals stated in the *Caulkins* case, at page 484 of the opinion:

> "Where statutory standards are lacking, statutory language is to be read in its natural and common meaning. Helvering v. William Flaccus Oak Leather Co., 313 U.S. 247, 249, 61 S.Ct. 878, 85 L.Ed. 1310; Kales v. Commissioner, 6 Cir., 101 F.2d 35. In the present case, the promise was to pay $20,000 at the expiration of the ten-year period. Clearly $20,000 was the amount received on the retirement of the certificate, and under the plain

> wording of §117(f), it was taxable as a capital gain. A provision that the increment in such cases should be taxable under §22(a) might or might not have been wise and fair; but Congress has not enacted it, and the courts cannot supply it by judicial legislation."

It is submitted that the *Caulkins* case was decided correctly by the Court of Appeals for the Sixth Circuit in 1944 and properly followed by the Commissioner until he reversed his position again on this issue in 1955. No good reason appears why Section 117(f) of the 1939 Code and Section 1232(a)(1) of the 1954 Code are not applicable to the investment certificate involved in this case.

Respectfully submitted,

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